Japan Tax & Legal Inbound Newsletter

2022 tax reform changes to scope of earnings stripping rules and the potential impact on Japanese real property investment by foreign investors

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In Brief

The scope of the Japanese earnings stripping rules was expanded to cover direct investment in Japanese real property by foreign investors for fiscal years commencing on or after 1 April 2022. This change could adversely affect the after-tax profitability of such an investment. This article discusses such a potential impact with an illustrative example.

Overview of the Japanese earnings stripping rules

The following is a brief overview of the Japanese earnings stripping rules:

- The earnings stripping rules restrict deductions for net interest expenses that exceed 20% of adjusted taxable income ("Tax-EBITDA").
- "Net interest expenses" are defined as the sum of the interest on loans (excluding interest that is fully subject to Japanese corporate income tax) less the sum of certain interest income.
- Tax-EBITDA is calculated using the following formula:

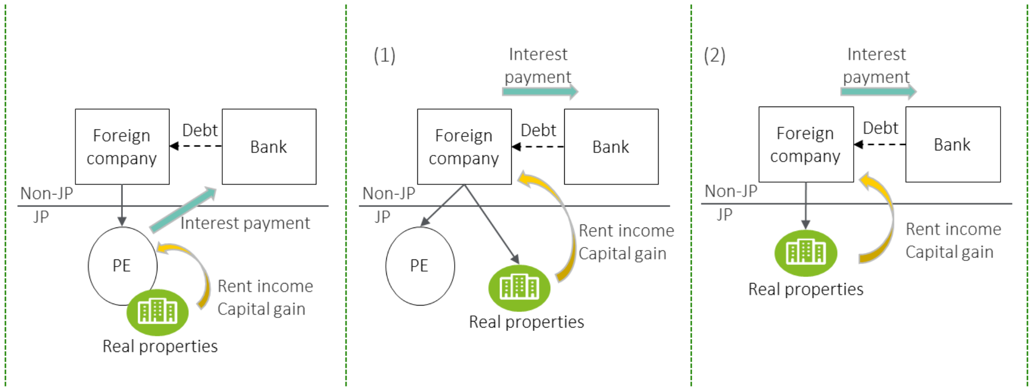
Taxable income
+) NOL Deduction
+) net interest payment
+) depreciation expenses
+) bad debt losses, etc.
Tax-EBITDA

- Disallowed interest expenses may be carried forward and deducted from taxable income in the succeeding seven fiscal years.
- There are certain exceptions to the earnings stripping rules. A de minimis rule applies in the event that (1) net interest expenses are JPY 20 million or less or (2) the sum of interest expenses of a domestic group (i.e., no foreign corporations included) exceeds the sum of 20% of the Tax-EBITDA of such group.

Extension of the scope of the earnings stripping rules

Prior to the 2022 tax reform, the earnings stripping rules were applicable only to Japan-source income attributable to a permanent establishment (PE) of a foreign corporation, and, accordingly, the rules were not applicable to the following:

- Japan-source income not attributable to a PE in Japan of a foreign corporation; or
- Japan-source income of a foreign corporation without a PE in Japan.



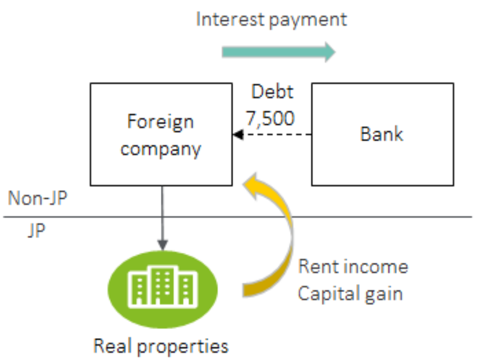
Pre reform	Applicable	Not Applicable	Not Applicable
Post reform	Applicable	Applicable	Applicable

Under the 2022 tax reform, the scope of the earnings stripping rules was extended to cover scenarios (1) and (2) above, with effect as from fiscal years commencing on or after 1 April 2022.

Potential impact on Japanese real property investment by foreign investors

Prior to the 2022 tax reform, interest on acquisition indebtedness was fully deductible in calculating Japan-source income of a foreign corporation arising from Japanese real property investments (e.g., rental income and capital gains), as long as the interest was not attributable to a PE in Japan. However, the deduction of such interest may be partially or wholly limited after the 2022 tax reform as per the revised earnings stripping rules, which could adversely affect the after-tax profitability of direct Japanese real property investments by foreign investors. The following is an illustrative example:

- In fiscal year one, a foreign company directly invests in Japanese real property and finances 75% of the acquisition from a third party lender;
- From fiscal year one to fiscal year four, the foreign company derives rental income from the investment and pays interest on the debt from the third party lender; and
- At the end of fiscal year four, the foreign company transfers the investment to a third party buyer.



(Unit: million JPY)

- Acquisition price of real properties
  - Building : 5,000
  - Land : 5,000
- Acquisition financing
  - Debt : 7,500
  - Equity : 2,500
- Annual rent income : 400
- Annual depreciation expenses : 100 (5,000÷50 years)
- Annual interest payment : 150 (7,500×2%)
- Sales price of the real properties at FYE4 : 10,500
- Capital gain : 900 (10,500 – 4,600 (5,000 – 5,000/50 ×4 years) – 5,000)
- Corporate Income Tax ("CIT") : 25.6% (national tax)

Prior to the 2022 tax reform (Unit: million JPY)

	FY1	FY2	FY3	FY4
Rent income (FY4: + Capital Gain)	400	400	400	1,300 (400 + 900)
Depreciation expenses Interest payment	100 150	100 150	100 150	100 150
Taxable income (a) (before earning stripping rules)	150	150	150	1,050
Earning stripping rules (b): - Disallowed interest expenses	-	-	-	-
Taxable income ((a) + (b))	150	150	150	1,050
CIT (×25.6%)	38	38	38	269

Total CIT
383

Total CIT increases by 26

CIT increases due to limitation of interest deduction under the earnings stripping rules

(FY1~FY3) Earning stripping rules

Tax-EBITDA :
Taxable income (a) 150
+) Depreciation 100
+) Interest payment 150
= 400

Disallowed Interest expenses :
150 – limitation 80 (400×20%)
= **70**

Pursuant to the 2022 tax reform (Unit: million JPY)

	FY1	FY2	FY3	FY4
Rent income (FY4: + Capital Gain)	400	400	400	1,300 (400 + 900)
Depreciation expenses Interest payment	100 150	100 150	100 150	100 150
Taxable income (a) (before earning stripping rules)	150	150	150	1,050
Earning stripping rules (b): - Disallowed interest expenses*	70	70	70	▲110
Taxable income ((a) + (b))	220	220	220	940
CIT (×25.6%)	56	56	56	241

Total CIT
409

*Disallowed interest expenses can be carried forward to offset future taxable income for 7 years

(FY4) Earning stripping rules

Tax-EBITDA :
Taxable income (a) 1,050
+) Depreciation 100
+) Interest payment 150
= 1,300

Disallowed Interest expenses :
150 – limitation 260 (1,300×20%)
= **▲110**
(interest expenses disallowed for FY1~FY3 are deductible up to 110)

Deloitte Japan's View

For fiscal years commencing on or after 1 April 2022, the earnings stripping rules may be applicable to direct investment in Japanese real property by foreign investors. Accordingly, due consideration should be given to the impact of the revised Japanese earnings stripping rules in assessing the after-tax profitability of an investment.

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